

MR. HERZENBERG: Mr. Chairman, members of this distinguished panel, my name is Stephen Herzenberg. I'm the Executive Director of the Keystone Research Center. I appreciate the opportunity to address this Commission.

Today, I will first consider the impact of trade on Pennsylvania and Pittsburgh. I will then use the experience of the auto industry to raise a broader question about the neoclassical economic framework. Is it the most powerful tool for thinking about trade and economic integration and a good guide to public policy? My own view is that it is not.

Pennsylvania and Pittsburgh were almost synonymous with the post-World War II manufacturing-based U.S. economy. In 1970, manufacturing accounted for 35 percent of Pennsylvania jobs. Unions negotiated middle-class wages for blue-collar workers in steel mills, coal mines, and apparel shops. As a result of its manufacturing jobs, the state, in 1979, had one of the nation's most equal family income distributions.

The shrinkage of the manufacturing sector, accelerated by the trade deficits of the early 1980's, hit Pennsylvania hard. From 1970 to 1995, Pennsylvania lost 39 percent of its manufacturing jobs; the rest of the United States lost less than two percent.

In the 1980's, the most difficult decade for U.S. working people since the Great Depression, western Pennsylvania saw its household income decline by more than all but two U.S. states. Using one measure of family income equity, Pennsylvania also plummeted from second in the income equity rankings to 26th.

When major plants shut down, places that symbolized a century of industrial development and a century of American history began to resemble ghost towns -- Braddock, Aliquippa, McKeesport, Duquesne, Beaver Falls, Monesson, Homestead. In Homestead, the U.S. Steel Works that Andrew Carnegie bought in 1883 closed its doors in 1986. As well as factories, a way of life and the communities the factories sustained, disappeared.

For Pennsylvania and Pittsburgh, the 1990's have been a better decade, but working people have not recovered the ground they lost. For example, the wages of men in Pennsylvania are still \$1.80 per hour behind where they were in 1979; African-American men are \$3.21 behind. In 1997, if she or he worked full-time, full-year, the median wage Pittsburgh area worker earned \$5,000 less to pump into the local economy than in 1979.

Job growth in Pennsylvania remains sluggish relative to the rest of the country. Job growth in Pittsburgh remains sluggish relative to the rest of the state. So far, in sum, Pittsburgh's efforts to redefine itself as a high-tech, post-industrial city are not expanding economic opportunity for working people.

Let me now switch gears and address the broader economic consequences of trade based on the experience of the U.S. auto industry. This year, automobiles and parts account for a trade deficit in the neighborhood of \$100 billion. Since the 1970's, production within the U.S. auto industry has been revolutionized, in part, because of imports from Japan and Japanese foreign direct investment.

Many analysts have seen this transformation as having unambiguously positive effects. In 1990, for example, MIT's International Motor Vehicle Program predicted that industry restructuring based on the Japanese lean production model would raise productivity and quality, lead to efficient assembler-supplier networks, and create rising wages and more rewarding jobs for production and white-collar workers. It hasn't quite worked out that way.

To be sure, auto assembly plants experienced dramatic improvements. In research using

plant-level data from the Annual Survey of Manufacturers, David Campbell and I found that value-added per labor hour in assembly plants rose 7.5 percent annually from 1978 to 1988. But in auto parts plants, the productivity story is quite different. From 1978 to 1988, value-added per labor hour in auto parts plants fell by 0.4 percent annually. From 1988 to 1996, auto parts productivity growth picked up slightly, but remained only 1.4 percent annually.

Simultaneous with low productivity growth in parts plants, auto employment has shifted to low-wage plants. From 1978 to 1997, the number of UAW members in the auto industry fell from about 900,000 to about half a million. Production worker employment in non-union U.S. parts plants mushroomed upwards, from 130,000 to half a million. Employment in Mexican maquilas that make auto parts to export north rose from less than 10,000 to 170,000.

A major incentive for these employment shifts within the United States, as well as to Mexico, has been wage differentials. Wages in U.S. auto suppliers were level with assembly company wages after World War II but only 60 percent as high in 1989. In non-union suppliers, workers in 1989 earned about half of what they did at assembly companies.

Dan Luria's analysis of 2,000 small manufacturing establishments, many of them auto plants, support the hypothesis that the expanding employment share of low-wage, low-productivity plants is dragging down U.S. economy-wide performance. A quarter of Luria's sample has falling productivity. Just over half has stagnant productivity.

The good news is that a top tier of small firms have very rapid productivity growth. These high-performing establishments have high capital per worker, pay high wages, use more technology, and spend more per worker on technical training. The bad news is that these plants are often undercut by demand volatility which leaves their expensive capital idle and by the ability of lower wage shops to out compete them on wages and on price.

Most neoclassical economists think of competition as a type of natural selection that automatically improves industrial performance through the survival of the fittest, most efficient firms. The experience of the auto parts industry suggests an alternative selection process, a kind of unnatural selection that one might call survival of the fattest - of the least lean and productive plants.

Trade can and does reinforce domestic pressures that create the potential for such unnatural

selection. The credible threat of moving production offshore facilitates the ratcheting down of wages, while reducing the incentive to improve performance. Sharp increases in imports may be particularly damaging. Such increases threaten capacity utilization, profitability, and survival at already struggling, high-productivity firms.

Trade deficits and natural selection can feed on one another, with imports reorienting production toward techniques that lower-wage countries can master, leading to more imports and so on.

The conceptual point is that competition and trade can operate in constructive or destructive ways. In the realm of sports, we take this for granted. The National Basketball Association's Competition Committee, for example, modifies the rules periodically to maintain audience appeal. Several years ago, the Committee instituted severe penalties for flagrant fouls and prohibited hand checking. The new rules help ensure that fluidity and athletic skill, rather than brute force and barely contained violence, remain the keys to success on the court. The Competition Committee, in other words, acted to discourage destructive competition.

The economic and trade world are also human constructs, not states of nature. They consist of

competition guided by rules. The issue is the type of competition that the rules encourage. Today, trade rules and domestic policy too often encourage low-wage, low-skill competition and fail to encourage improvement of economic performance. Better economic performance and social outcomes require better rules.

To be sure, the technical challenges and the politics of achieving better trade rules may be complex, but that is no excuse for pursuing trade policy with an almost willful disregard for the economic development process in key industries.

COMMISSIONER BECKER: Stephen, I think you know you're running over.

MR. HERZENBERG: Okay, this last paragraph?

COMMISSIONER BECKER: Go ahead.

MR. HERZENBERG: Okay. The opportunity this Commission has, it seems to me, is to bring the issue of trade and the development process to the center of U.S. debates, in part, through industry studies. The United States currently uses its enormous political power to manipulate trade rules in ways that serve the interest of powerful multinational corporations. It is time for the U.S. to use its power to promote mutually beneficial economic development at home and in our major trading partners.

Thank you.

COMMISSIONER BECKER: Kate?